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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Hungary

Report of the Secretary-General

SUMMARY

The goals of privatization in Hungary are to improve the performance and capacity of the economy and to establish a social and economic system based on private property. The Government attempted various measures beginning in 1968 to stimulate the economy, but they were largely unsuccessful. Most privatizations to date have occurred through joint ventures, spontaneous privatizations, public offerings and competitive bidding methods. Maintaining the Government's ambitious time schedule has been difficult because of the lack of capital, uncertainties about property ownership, inadequate accounting and financial information and inflexibility of governmental regulations. Despite the shortage of capital, the Government has opposed coupon investment schemes which are being used in other Central and Eastern European countries because it fears that enterprise ownership might become too diluted. New legislation and particularly the new accounting law should improve the situation. Historical data is used for pre-privatization financial statements unless foreign capital is being raised. In those cases, an independent fair market valuation is required by the State Property Agency. An audit by an independent accountant is also prescribed by law.

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I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS 1/

A. Objectives of privatization

1. Hungary's first steps towards a market economy started in 1968 with the institution of the New Economic Mechanism. On the first day of January the Government completely abolished the short-term command system and allowed state-owned enterprises autonomy in short-term input and output planning (Kornai, 1986, p. 1693). These reforms, which combined elements of both planned and free market economies, expanded management's decision-making prerogatives and gave much more leeway to state-owned enterprises to finance investments from their own assets or borrowings.

2. Ostensibly, the main objective of state-owned enterprises under the New Economic Mechanism was to maximize long-term profitability. However, there were powerful disincentives connected with the inconsistency and unpredictability of the Government's taxation and subsidy policies. In effect, revenues flowing in from state-owned enterprises in good financial condition were being reshuffled to keep other state-owned enterprises afloat. This meant that special taxation and subsidy rules were applied to meet particular circumstances. The focus of bargaining between state-owned enterprises and the Government shifted from plans, as under the former direct command system, to regulations.

3. Decentralization was pushed further with a new series of reforms in the late 1970s and early 1980s (Richet, 1989, pp. 6-7). To encourage enterprise competitiveness and provide more flexible administration, some 300 new enterprise units were created. The former single-bank system was also broken up, and new, specialized deposit and commercial institutions established. In addition, off-shore and joint stock banks were created which could operate domestically and overseas in both domestic (Hungarian) and foreign currencies.

4. The introduction of interfirm contracting later in the 1980s was a major innovation aimed at expanding industrialization by encouraging the development of small and medium-sized state-owned enterprises and acquiring new technology and know-how through cooperation with western interests. Hungarian state-owned enterprises were permitted to establish subsidiaries or joint ventures with domestic or western companies or enterprises in other socialist countries. These foreign partners could own majority interests and repatriate their profits.

5. Growth of the formal private sector was further encouraged by new legislation allowing the creation of small, service-type firms, whose customers paid according to results, and also by work collectives. A collective, which could belong to either a state-owned enterprise or an independent firm, consisted of between 2 and 30 members who contracted with the parent enterprise to provide services otherwise unobtainable because of labour shortages. Contracting out in this way became a popular vehicle for avoiding certain problems associated with regulated wage rates and working conditions, and work collectives soon numbered in the thousands.

6. While the authorities were experimenting, in piecemeal fashion, with different ways of opening up the stagnating economy, Hungary was slipping into a deepening recession. Its gross hard currency obligations which stood at just over $9 billion in 1980 more than doubled during the next decade, reaching $20.6 billion by the end of 1989 and representing Europe's highest per capita debt.

7. With the state sector accounting for 80 per cent of productive assets and 90 per cent of the national wealth, lack of entrepreneurial spirit at the enterprise level was reflected in the lack of concern over the efficient administration of resources. By the spring of 1988, general dissatisfaction with the economic situation was a major factor in bringing about a series of political changes which eventually led, in the fall of 1989, to a programme of peaceful transition to democracy. Not only were there calls for the transformation of the economic and state ownership structures, but also the financial system needed further modernization, a free market had to be developed, and the nation's foreign economic relations had to be reoriented towards new trading partners and investors, preferably in the West. Foreign capital and technology were needed for the country's industries.

8. The first major attempt to modernize the banking system occurred in 1987 when the previous single bank approach was replaced with a two-tiered structure. The National Bank of Hungary remained the central bank of issue but its business activities were divided among 13 commercial banks for which the National Bank has oversight responsibilities and in which it has majority shareholdings. Further decentralization took place in 1989 when the National Bank gave up its monopoly on foreign exchange, enabling commercial banks to make hard currency loans. This was followed by the establishment of joint venture banks and financial institutions with international capital participation.

9. Tax reforms aimed at improving the state budget and the public finances were introduced in January 1988 when Hungary became the first member of the former Council for Mutual Economic Assistance (CMEA) to introduce a value-added tax (VAT), and a step-wise personal income tax, with basic rates of 25 per cent and 20 per cent, respectively. In addition, a uniform rate of company income tax was introduced to take the place of individual rate negotiations between companies and the tax authorities.

10. Currency convertibility would, of course, help Hungary substantially in its efforts to expand trade with the West. In recent years, balancing foreign trade became particularly critical when, in common with other former CMEA partners, Hungary lost its Soviet markets and was running very large transfer rouble surpluses. Foreign trade was facilitated during the last half of the 1980s when increasing numbers of companies were granted foreign trading rights, and those rights have been extended to any type of enterprise which meets certain conditions. In related efforts aimed at encouraging foreign investment, changes were introduced in the joint venture regulations at the beginning of 1986, and further liberalized later, to simplify the licensing and registration requirements, provide for certain tax advantages, such as

holidays and rate reductions, and to allow for majority or complete foreign ownership.

11. The legal framework for joint ventures and other forms of commercial enterprise is provided by Act VI of 1988 on Economic Associations (the Companies Act), 2/ which went into effect as of 1 January 1989. Six legal forms are available to new businesses: public limited company (Rt.) and limited company (Kft.), general partnership (Kkt.) and limited partnership (Bt.), trade association, and joint venture (Kv.). The two types of limited companies and partnerships follow German structures closely; the trade association has unlimited liability and must be non-profit; and the joint venture, which also has unlimited liability, is profit-oriented, and its own statute spells out various capital-contribution and profit-sharing arrangements.

12. Hungary launched its first privatization programme in September 1990. The economic aims were, by transferring half the economy to the private sector within five years, to optimize the contribution to state revenue, increase the efficiency and competitiveness of Hungarian industry, assist the development of Hungarian capital markets, and promote employee share ownership (Yates and Knight, 1990). Excluded from this process is reprivatization or the return of nationalized property and assets to the original owners. The financial harm suffered by former owners of property has been provided for in the Compensation Act (1991).

B. Economic, financial, and social conditions

1. Availability of local capital

13. Several factors constrain possibilities for the development of the private sector. Hungarian citizens, even though they may be employed in more than one capacity, have low salaries by western standards and, therefore, a low savings base for investment purposes. It has been estimated that if one compares the book value of the net assets of all state-owned enterprises - about 2,000 billion Hungarian forints, or about US$ 30 billion - with the current annual flow of private savings that might be available for purchasing assets other than real estate - which does not exceed Ft 20 billion, or about $300 million - it would take about 100 years for Hungarians to purchase state enterprises at the current savings rate (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, p. 21).

14. Therefore, apart from encouraging foreign direct investment, the Government needs to find some mechanism for permitting Hungarian citizens to participate in purchases of national assets. One approach, which is to be adopted in Czechoslovakia, Poland and Romania, is to develop a system for the distribution of privatization coupons, either free or for amounts within the financial capacity of average citizens, which would allow them to participate, directly or indirectly, in share issues. Hungary has decided against this for two main reasons: it wants to concentrate, rather than disperse, ownership so

that there would be greater pressure on management to perform efficiently from a shareholder group; 3/ and it needs budget relief, since its domestic debt in 1990 was about Ft 1,200 billion (about $15 billion), or roughly half the book value of state-owned enterprises. Another approach, suggested by the Blue Ribbon Commission (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, p. 21) is to support the privatization programme with a plan to make loans available to Hungarian citizens for equity purchases and to give employees special privileges in acquiring shares through techniques such as free shares for improved productivity or preferential loan arrangements. Some of these philosophies are reflected in the Government's policies. Employees in privatized companies will be able to purchase about 10 per cent of available shares at reduced prices and can obtain subsidized credit of up to 80 per cent of the purchase price if they wish to acquire additional shares. Additional motivation to buy shares is provided in the new tax provisions which took effect at the beginning of 1991 which permit taxpayers to offset their investments in shares and joint ventures against their taxable income (Grosfeld and Hare, 1991, p. 138).

15. Typically, foreigners own about one third of the industrial holdings in many small western European countries (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, pp. 40-41). So, the level of foreign investment in Hungary, where only some 3-4 per cent of the productive assets are foreign-owned is, comparatively, extremely low. Looking at the industrial picture alone can, however, convey an erroneous impression of foreign investment interest. By June 1991, there were some 1,200 companies with investments in Hungary, and 7,000 registered joint ventures. Considering the fact that 2,000 of the joint ventures were registered in the first quarter of 1991, it is evident that foreign investment is accelerating. Partial trade statistics show that just under 27 per cent of the joint ventures are engaged in tourism and retailing, 22 per cent are in manufacturing, and just over 11 per cent in construction.

16. With local resistance to foreign ownership reversed, foreign capital invested in Hungary now amounts to $1.8 billion, and the Government hopes for a further 70-80 per cent of this amount to be added in the next 18 months. The United States is the leading investor ($650 million), followed by Germany ($350 million) and Austria ($300 million). To make investment easier and more attractive, some amendments to the Foreign Investment Law were passed in 1991. They included eliminating the special licence requirement for establishing a joint venture, removing restrictions on convertible currency, and allowing dividends from one venture to be used as investment funds in another. By aggressively courting direct foreign investment and successfully steering foreign funds in the direction of productive resources, possibilities arise for the Government to reduce some of the foreign debt by earmarking foreign currency privatization proceeds.

2. Existence of capital markets 4/

17. Hungary has had long experience in capital market operations. The Budapest Commodities and Stock Exchange opened in 1867 and was closed by the socialist authorities in 1948. After 35 years, the securities market opened its doors again in 1983, but the number of transactions did not become significant until 1987 when bond volume doubled to Ft 17 billion. This was the same year that the two-tier banking system was established, and the bond market's success sparked interest on the part of the newly created commercial banks and some other institutions to organize and operate a formal capital market.

18. In the meantime, a Securities Trading Agreement was formed. By 1990 it had 24 banks and financial institutions and three brokerage firms as members. They were to be the nucleus of the future stock exchange which they were pledged to establish, while in the meantime they were to coordinate securities trading in Hungary, collect information on the securities market, and disclose that information to the public. By January 1990, a Stock Exchange Council, an Ethics Committee, and a Securities Trading Committee had been formed and were operating.

19. Time was now ripe for the introduction of legislation governing the issuance of, and trading in, capital instruments, the establishment and operations of a stock exchange, and arrangements for state supervision of the institution and of trading. These are encompassed in the Act on Securities and the Stock Exchange, which came into force in 1990. The Act defines the stock exchange as a legal entity which may be founded by business entities authorized to engage in securities trading so as to facilitate their securities transactions.

20. Part II of the Act defines the legal status, tasks, and scope of the State Securities Surveillance. Its head is appointed by the Council of Ministers, and it operates under the supervision of the Minister of Finance, who specifies its organizational structure and *modus operandi*. A certain measure of independence is provided for in that its resolutions can neither be annulled nor revised in any supervisory capacity, nor is there any recourse against them except as they may be, with certain exceptions, revised by a court of justice.

21. Much of the hard work in building up the securities market has yet to be done. To create a much greater volume of trade, there has to be a greater volume of securities; confidence in the market has to be built up and some measures created to encourage demand; securities brokers have to be trained; the financial community has to learn how to work with financial information; and the statutory auditors have to learn their functions. One event that would add impetus to Hungary's drive to develop its capital markets would be convertibility of the forint.

C. Enterprise circumstances

22. The severe financial difficulties which large Hungarian state-owned enterprises faced in the late 1980s led to the phenomenon of spontaneous privatization when no government bailouts were available and there was no time for financial restructuring to keep an entity together. Privatizing spontaneously essentially consists of a state-owned enterprise unilaterally deciding to sell off some of its assets for some business purpose, such as paying its debts or making necessary purchases or investments. This approach was pioneered in 1987 by Medicor, Hungary's largest producer of medical instruments, when it restructured 10 of its plants into joint stock companies and sold their shares to various investors. Although, theoretically, the proceeds belonged to the nation, they stayed in the company, providing management with a way out of some of its problems. Other large companies readily followed suit, and by 1990, some 150 companies had adopted spontaneous privatization, taking advantage of its relative simplicity and the opportunity it provided managements to hold on to their positions.

23. A negative aspect was the built-in opportunity that existed for conflicts of interest. The restructuring process is largely out of the public view, as are the processes for determining share values and identifying buyers. The four major problems that spontaneous privatization poses have been classified as financial, economic, political, and organizational, as described below (Lee and Nellis, 1990, p. 11):

> Financially, the former managers become owners without paying a "fair price" - though the determination of a "fair price" for enterprise assets is one of the most difficult technical issues in the transition from a socialist to a market economy. Economically, it is hard to see why turning the firm over to the people who ran it poorly in the past makes allocative sense - though as owners rather than agents they might be operating under a dramatically different incentive system. Politically, the new owners will be either former "nomenklatura", whose shift from party elite to asset owners most people in socialist countries would regard as intolerably unjust; or groups of workers (or some combination thereof). Turning enterprises over to workers might be acceptable were it not for the equity problem; i.e. worker ownership might be fine for those employed in profitable or potentially profitable firms, but not for those in persistent loss-making operations or those currently unemployed (and what about professionals, civil servants, farmers, etc.?). Organizationally, denying ownership to the former managerial group eliminates those with the experience and know-how to run the firms.

24. Spontaneous privatization was provided for in the Companies Act and the 1989 Transformation Law. The latter attempts to transfer state assets to the owners at realistic fair market prices.

25. As more spontaneous privatization took place and the wisdom of allowing these processes to continue unchecked was hotly debated, the Government moved to establish control by creating the State Property Agency, as of

1 March 1990. The Agency has two main functions: to approve every transaction in excess of a defined minimum value which involves the transfer or use of state-owned property through sale, rent, lease etc.; and actively to promote, assist, and regulate the privatization of certain groups of state-owned enterprises within the framework it had established.

26. Privatization efforts thus became centralized through the State Property Agency, which, through a July 1990 amendment to its founding legislation, came directly under government control. Organizationally, it is supervised by a board of directors headed by a minister without portfolio, and its staff numbers about 100. Among the senior staff are four independent experts nominated by the opposition parties and the Chamber of Commerce, and officials from five government ministries. In September 1990 the scope of its activities was broadened to require Agency approval of the form of economic association which a transforming state-owned enterprise intended to adopt. Further, the reorganization contract was to be signed by the Agency and not the company (Grosfeld and Hare, 1991, p. 138). This measure reduced any ambiguities about the State's acquiescence in the handling of socially owned assets. The advantages of oversight, orderliness, and consistency in privatization processes were tempered, however, by the disadvantages of a slowing down in progress. During the period from March 1990 through 31 March 1991, about 160 privatization cases came before the Agency: 40 were approved, with a total value of Ft 70 billion (about $1.1 billion).

II. HUNGARY'S PRIVATIZATION METHODS

27. Until the creation of the State Property Agency, spinning off segregable parts of a state-owned enterprise, transforming them into companies, and selling their shares privately had constituted the main privatization technique. Investors from other countries were primarily interested in acquiring assets and not shares of companies, in order to avoid problems of liabilities and having to retain excessive numbers of employees.

28. In September 1990 when the Agency announced its first privatization programme, three types of privatization were identified: those initiated by the State; those by the enterprise; and those initiated externally. In addition to spontaneous privatization, which, under Agency control, was still an acceptable and important option, and leasing, three main methods were proposed for individual privatization which could be used singly or in combinations: public offer of shares and listing on a stock exchange; competitive bidding, either open or limited to pre-selected bidders; and employee-share ownership plans.

29. One of the main reasons for using a public offer would be to attract small investors. The state-owned enterprise would be transformed into an incorporated company under the Transformation Act and go through the usual preparatory procedures for a stock exchange listing. That is, the accounts would have to be audited, a prospectus prepared with the financial data verified by the auditor(s) and, possibly, an asset valuation carried out.

30. Competitive bidding is mainly intended for the sale of shops and transportation equipment, and either an entire concern or parts of it could be offered for sale. Under an open tender, the letter of invitation to bid would describe the participation conditions and requirements and any restrictions on asset use. Pre-selection of bidders would be considered appropriate when the new owner's identity and intentions could have an important bearing on what are perceived to be the nation's long-term interests.

31. Employee-share ownership plans contemplate a range of from 5 to 15 per cent ownership by employees for the majority of the selected privatization candidates. Higher employee participation would be considered under special circumstances; for example, if employees benefit directly from enterprise performance, the size of the workforce is relatively small, and prospects for attracting external investment are poor.

32. The first privatization programme, announced in September 1990, was relatively ambitious. It called for some 505 enterprises to be privatized by state initiative during the three years 1991-1993. The Ministry of Industry and Trade conducted a survey of all wholly or partially state-owned companies, which compiled the following information on each company:

(a) Efficiency and profitability;

(b) Annual net sales;

(c) Amount of debt outstanding;

(d) Operating characteristics (e.g., products manufactured and sold, production and productive capacity, labour and management size and qualifications).

The official government objective was to reduce ownership to below the 40-50 per cent range, and after analysis, the Government decided that the 505 enterprises should be classified as follows:

(a) Companies in which the Government would retain at least a 51 per cent interest for national policy purposes;

(b) Companies in which a 51 per cent interest would be owned by a combination of state ownership and ownership by Hungarian citizens;

(c) Companies for which there would be no restrictions as to ownership of shares by the State, Hungarian citizens, or foreign shareholders.

Table 1 shows the number of companies, relative size characteristics, and revenues which the State expected to realize from the privatization of the 505 companies.

Table 1. Summary of industrial and trading enterprises selected by the Hungarian Ministry of Industry and Trade for privatization, October 1990

	Number of companies	Net sales revenues (Millions of forint)	Total staff	Estimated net profit in latest year (Millions of forint)	Total assets at end of latest year (Millions of forint)	Expected revenues to the State from privatization (Millions of forint)
51% of the shares to remain state-owned	64	828 647	157 326	50 700	477 820	142 686
51% of the shares to be owned by the State or by Hungarian citizens	21	164 456	39 697	6 760	95 974	29 149
No restrictions on domestic or foreign ownership	420	943 386	642 072	22 931	646 852	401 771
Total	505	1 936 489	839 095	80 391	1 220 646	573 606

Source: International Training Centre for Bankers, Ltd., Budapest.

33. The companies were then classified as to what needed to be done in order to accomplish the privatization programme. The best of the group were operating efficiently at the time and therefore required little or no restructuring. Others required relatively small investment by the State or by private investors in order to be run successfully. Another group required major investments in capital, management and professional skills, and the infusion of modern technology. For this latter group, the Government anticipated that the private sector, either domestic or foreign, would have to provide the resources to attain successful privatization. In the last group were companies in which the State did not intend to make any further investments, and if the companies could not be sold in their existing condition, the enterprises would be liquidated. Table 2 is a summary of the number of companies in each of these groups, with further classification by size of the enterprises.

Table 2. Classification of planned privatization of industrial and trading enterprises

	Number of companies				
	Small	Medium	Large	Trust	Total
Efficient companies which could be privatized without any preparation	21	108	94	10	233
Companies that could be privatized after minor investments in capital and other resources	3	27	21	4	55
Companies that required major investments in capital and other resources, primarily from non-governmental sources	52	88	28	2	170
Companies to be sold without investments or to be liquidated	6	29	8	4	47
Total	82	252	151	20	505

Source: International Training Centre for Bankers, Ltd., Budapest.

34. The strongest companies were to be sold by share offerings. Self-initiated privatizations are expected to be received from 300-400 state-owned enterprises during this same time period. The programme anticipated receiving a significant number of external proposals to purchase state property, particularly state-owned enterprises classified as small or medium sized, or to buy shares in state-owned companies.

35. The new programme for such foreign or domestic offers was announced in January 1991 and committed the State Property Agency to respond one way or the other within 30 days. As an incentive to the State Property Agency to speed up the process and to would-be investors to make proposals, the Agency is required to hand down a formal decision within 30 days on any western proposal to transform a state-owned enterprise into a company. The contract may be assumed to have been accepted if no response is made within this time limitation.

36. Within three to five years, the Government wants to privatize completely the construction industry and all companies engaged in wholesale and retail trading activities. Because of a significant reduction in sales to the former USSR, the success of many other companies depends on a restructuring of their products and markets. The Government also wishes to eliminate monopolies in many processing industries such as paper and concrete manufacturing.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

37. The planned sale of the first 20 companies 5/ under the State Property Agency's programme was announced in September 1990, and it was expected that the process would be completed in 1991. The enterprises were from all sectors of the economy and had better-than-average operating performance. Their annual revenues amounted to approximately Ft 100 billion, and the value of their total assets was estimated to be approximately Ft 70 billion. The programme was expected to produce between Ft 30 billion and Ft 40 billion in revenues to the State.

38. For various reasons, plans ran very far behind schedule, and by July 1991 only one of the companies, Panonplast, was ready for privatization. Other major candidates which followed were engaged in a very wide variety of activities, and this variability was also present in the range of book values, revenues, and profits, as well as the proposed privatization methods.

39. In terms of asset values, Richter Gedeon Chemicals (Ft 17,481 million) and Hungarhotels (Ft 10,935 million) led the field, together accounting for over 42 per cent of the total. The two top revenue earners were Centrum Department Stores (Ft 18,610 million) and, again, Richter Gedeon Chemicals (Ft 15,576 million), together accounting for over 36 per cent of the total. The most profitable was Ibusz Travel, whose profit of Ft 1,139 million represented 16.8 per cent of the total profits of the group, as well as 53 per cent of its own assets of Ft 2,144 million and 12.08 per cent of its own revenues of Ft 9,428 million. The proposed privatization methods for

these four companies are described below (Grosfeld and Hare, 1991, pp. 154-155) so as to convey some sense of the diverse activities that occurred:

(a) Richter Gedeon Chemicals: share offering

Share capital is to be raised by 50 per cent during privatization. Foreign ownership may not exceed 33 per cent and Hungarian majority ownership must be maintained. Small investors are to be allotted 15-25 per cent, and employees 5-10 per cent, of the issue, which is to be sold through the Budapest Stock Exchange;

(b) Hungarhotels: technique under consideration

This hotel chain was purchased by a Dutch/Swedish consortium in 1989/90, but the contract was annulled because of what were perceived as highly unfavourable terms for the Hungarian interests. A decision had not yet been reached as to whether to proceed in stages or to sell off hotels individually. A Hungarian majority interest is to be maintained, with possibilities for participation by small Hungarian investors;

(c) Centrum: restructure and share offer

Organizational restructuring will unite certain key operating units into one joint stock company (Rt.), wholly owned by Centrum as a holding company. Foreign participation in shares of the joint stock company will be permitted, but limited to 30 per cent. Some employee participation in the holding company shares is contemplated. At least 40 per cent of the Centrum shares are to be issued through the Budapest Stock Exchange;

(d) Ibusz: public share offering

A 40 per cent interest was sold on the Budapest and Vienna Exchanges in June 1990 and was heavily (23 times) over-subscribed. After a number of gyrations, share prices fell back to their initial levels, so investment success has not been uniform. As long as the State holds 33 per cent of the shares issued, it will retain majority voting control. Exact details of the new share offering are being worked out, and a "golden share" arrangement may be contemplated.

40. In selecting the first 20 candidates, a number of criteria were used by the State Property Agency, including satisfactory enterprise performance, support from management and employees, potential investor demand, possibilities for using various privatization techniques, and any previous privatization preparations (Zoltan, 1990, p. 10).

41. Shortly after the first privatization programme had been made public, 6/ the State Property Agency issued an invitation to bid for the necessary consulting services, and some 200 expressions of interest, including 50 foreign, were received, requesting the general and enterprise-specific terms

of reference. Successful bidders would be expected to carry out the privatization involved, so their proposals had to include such details as future business strategy, modernization and capital requirements, methods to be used, and timing schedule. Personal data about each bidder were also required, including a description of the firm, its staff, and its experience plus the amount of the fee and a detailed budget. Weights of 3-1 were to be assigned to the quality of the proposal versus the proposed fee in the bid selection process.

42. For many of the tender offers, between 20 and 30 western and Hungarian firms submitted bids, putting considerable strain on the Agency's resources. But by the end of the year it had selected most of the banking and consulting firms that it needed.

43. In early December, the State Property Agency announced its second privatization programme, issuing a partial list of 24 companies which would be expanded to a total of 50 later. All of these companies had more than 50 per cent of their assets invested in joint ventures or in other subsidiaries. Existing investors would be permitted to expand their interests or allow others to participate.

44. While the first and second privatization programmes were getting under way, attention was also being directed towards the privatization of small shops and catering establishments. In 1989, there were just over 25,000 of such state-owned units, with 27 per cent of them employing over half of all the active employees in these two sectors and accounting for 57 per cent of the revenues. Efforts to decide on the final legislation ran aground, however, over the topic of foreign ownership, until it was finally decided that investment would be restricted to Hungarian citizens.

45. Act LXXIV of 1990, known as the "pre-privatization law", provides the legal framework for the privatization of the catering and retail trades and of some other small-scale service concerns. One of its main objectives is to strengthen the nation's middle class so transactions that are restricted to Hungarian citizens and only small establishments - that is, retail stores with a maximum of 10 employees and catering establishments with a maximum of 15 employees - are covered. A complicating factor lies in the problem of providing clear ownership title, since premises can only be sold outright to those who were the original owners. Otherwise, premises may only be leased with an option to purchase if and when circumstances permit. Lessees are, however, guaranteed a 10-year tenancy, and there are no restrictions on the resale of operating licences.

46. Once the law took effect, all state-owned enterprises owning units covered by the legislation had to provide the State Property Agency, within 30 days, with information about ownership, asset values, and form of operation, as well as whether they had any prior privatization transactions, what their privatization intentions were, if any, and what would or could be the implications of future privatization. Without the Agency's approval, the state-owned enterprises no longer had the legal right to sell, contract out,

or in any other way transfer such units. It was then up to the Agency to determine the value of the units, set a minimum price, and request bids. In the event of equal proposals, the law defined a sequence of preferential treatment, as follows: the unit's manager; an employee of the unit; an economic association (that is, a company) of the unit's employees; employees of the unit's parent company or their economic association; and, finally, bidders offering a cash transaction.

47. The State Property Agency's time-frame for completing the process is two years, and it targeted some 1,565 retail stores - 1,000 of them located in Budapest - for privatization in the first six months of 1991. By the end of the first quarter, only 1 per cent of the premises available in the capitol had changed hands. This is understandable, given the restrictions on ownership, the lack of domestic capital, and the very high costs per square metre, particularly in the centre of the city. The situation was no better by mid-year, with only 100 shops and restaurants disposed of and blame being placed on the fact that reserve prices were set too high.

48. In addition to the limited ability to raise capital from Hungarian citizens, other factors which contributed to the relatively slow pace of privatization in 1991 were:

(a) Uncertainty about property ownership. There was a certain degree of insecurity caused by lack of settlement of certain ownership issues. This should be solved by the Compensation Act which was passed in 1991;

(b) Inadequate information systems. Records on land registry lacked sufficient information to establish clear titles to real property. The Government is modernizing its property information systems, which should alleviate many problems;

(c) Inadequate accounting information available to measure costs for environmental clean-up and related future liabilities correctly. Also, the method of recording depreciation on fixed assets was inflexible. The new Act on Accounting (1991) should solve most of these difficulties;

(d) Inflexibility of legal regulations on matters such as competitive bidding, management of state-owned property and environmental protection. Recent Government privatization strategies and amendments of laws are being directed to these issues;

(e) High inflation and high rates of taxation. The Government's economic policies are attempting to mitigate these problems.

49. As the privatization process continues, serious concerns have been expressed about the appropriateness of centralizing activities in an agency that is so short of resources. One proposal, put forward by the Ministry of Finance, would be to restrict the Agency's activities to particular groups or types of privatization, while others would be carried out by professionals under governmental supervision.

50. One decentralizing technique which the Agency has announced it will introduce is "asset handling", which is a form of contracting out for services. Bids will be solicited for contracts to protect and augment some of the assets or equities of certain state-owned enterprises. The contracts would be for three-year periods, and the contractor would be required, in return for a property handling fee tied to results, to achieve a minimum growth of 25 per cent of initial asset values.

IV. ACCOUNTING IMPLICATIONS

51. Under Hungary's previous political system, the accounting function was regulated through decrees of the Ministry of Finance, with primary emphasis on bookkeeping. To ensure uniformity in record-keeping and reporting, which was essential for calculating, among other things, national income, the bookkeeping function was organized around a compulsory general chart of accounts, using double-entry techniques, basic documentation and product costing systems, and standardized methods of valuation and financial statement preparation. In common with other systems of governmental accounting, equities were thought of and designated as funds, and assets as uses of those funds.

52. With passage of the Companies Act and the Transformation Law in the late 1980s, certain adaptations were introduced so as to accommodate the new forms of organization. These were reflected in the balance sheet with assets listed in sequence of decreasing liquidity, as in Anglo-American practice, with a new category of intangible assets added, and the various funds which made up the equity of the state-owned enterprises combined under the new title of "homogeneous property fund". This fund subsumed two different accounts: the property fund (or registered value) and changes in the property fund, which would include transactions not yet registered, such as current income. These two titles were changed once more, in 1989, when the property fund became the founder's property and the changes account was retitled "accumulated property".

A. Transition to commercial accounts

53. Despite these adaptations towards commercial practice, accounting still served macroeconomic needs rather than those of investors and creditors. This was reflected in both the design of the accounting and reporting systems and the types and quality of the information they produced.

54. Perhaps the most basic difference in the accounting system design in a non-market economy is the lack of distinction between financial and management accounting. In fact, enterprise financial management, in the western meaning of the term, does not exist. In other words, there is no formal accounting statement which analyses the sources and uses of cash, no use of present-value techniques to record the monetary effects of transactions timed to occur after one year, no accounting techniques to record or assess the effects of inflation, and no financial indicators developed to track and assess

enterprise performance, particularly in comparison with peer institutions. All of these accounting techniques are considered essential to help an enterprise maintain financial health and liquidity in a competitive environment.

55. Instead of analyses of enterprise growth through periodic performance evaluations based on objective standards linked to competitive factors, emphasis has been on the short term and has been equated with success in meeting budgeted targets in an environment which Kornai (1986) has described as one of "soft budget constraint".

B. Information required for privatization

56. In accordance with the Transformation Law, the following information must be provided for the State Property Agency:

(a) Planned date of the transformation and the name and address of the new company;

(b) Economic purpose of the transformation to a private enterprise, the planned share capital of the new company, a preliminary estimate of production and sales, and important expected results from the transformation (e.g., export sales, market expansion, investment, employment etc.);

(c) Information about the investors (other than the management and employees) in the company and what were the preliminary negotiations with them, including terms of their proposed investment;

(d) Latest available balance sheet of the enterprise;

(e) Description of the enterprise business activities, including main products and markets and their significance to the economy of Hungary, main suppliers, and past annual revenues from:

(i) Domestic sales;

(ii) Sales to other countries in the eastern European trading bloc (the so-called "rouble-based" market);

(iii) Sales to western countries.

57. For enterprises previously privatized, desiring to sell all or a portion of their shares to outside investors, the management of the enterprises must furnish to the Agency:

(a) Details of the offer, including the portion of company shares subject to the offer, the currency of the offer, the time of payment, and other conditions and guarantees;

(b) A copy of the draft and the final contract of sale;

(c) A copy of the auditor's letter of appointment and audit report.

If the contract of sale is with a single bidder and is for the majority of the shares in a company with Ft 500 million total assets or Ft 1 billion in net income, the Agency also requires the following information:

(a) Planned new investments and the financing source;

(b) Planned number of employees;

(c) Forecasted annual revenues, new products and new markets;

(d) Forecasted net income in hard (convertible) currencies;

(e) Estimated total market share of the combined acquiring company and the company being acquired, if it is expected to increase by 30 per cent from the previous year's sales.

C. Valuation of enterprises and the transformation balance sheet

58. The valuation information that must be submitted to the State Property Agency in connection with a proposed privatization will vary according to the size of the transaction. Small enterprises that want to sell their assets primarily to Hungarian citizens may use their existing financial statements to value the proposed transactions. Independent valuations are not required. For trade sales of large enterprises (with annual revenues and assets greater than Ft 500 million and Ft 300 million, respectively, or which employ more than 500 persons), a competitive bidding process is prescribed.

59. For each privatization of a large enterprise, the management of the enterprise must engage the services of a valuer to determine the fair market value of the state-owned property. The valuer reports to the enterprise and to the State Property Agency. The specific requirements for the valuation are specified in the decree of the Ministry of Finance 30/1989, VII.1. In making the appraisal of the enterprise, the valuer evaluates the assets and liabilities on the balance sheet and then makes an appraisal of the total business on a going concern basis.

60. Even when accounts are recast into a commercial format, various adjustments have to be considered when examining the basic financial data as a preliminary step in the valuation process. Some of the issues which have to be resolved are:

(a) Collectibility of receivables;

(b) Effects of excluding fixed manufacturing costs and of including variable selling expenses in production inventories;

(c) Possible decline in the market values of purchased and manufactured inventories below recorded amounts, including provisions for excess quantities and obsolescence;

(d) Proper ownership and valuation of land and buildings;

(e) Accounting for leases; in Hungary, all leases are considered to be operating leases and the capital lease accounting method is not followed;

(f) Valuation of intangible assets purchased or otherwise acquired, including appropriate accumulated amortization; in the past, intangible assets were not amortized;

(g) Provision for known or probable future liabilities; taxes on profits and dividends payable are currently not required to be recorded; also, provisions for potential losses from contracts, warranty claims, environmental obligations, etc. must be considered.

61. In addition to the valuation, the State Property Agency generally requires financial statements in accordance with international accounting standards for the past three years, along with a business plan and financial forecast for the next five years, a summary of significant contracts, and a description of significant contracts and investments.

62. If the Agency approves of the proposed privatization, the management of the enterprise must prepare an offering (tendering) booklet for submission to potential bidders. Based on this information, potential purchasers submit their bids directly to the enterprise for evaluation. The most important criterion is price, but attention is paid to the plans of the prospective investor for future operations of the enterprise.

63. Large corporations may also be privatized by share flotations. In such cases, the business valuation forms the basis for negotiating the price of the shares to be sold.

64. In accordance with Law No. XIII/1989, after the privatization has occurred the enterprise must prepare a "transformation balance sheet" which must be audited by a chartered accountant who is registered with the Ministry of Finance. This balance sheet must be based on the valuation that was made of the business. Assets are to be valued at replacement cost, existing use value, or disposal value, based upon the judgement of management and the auditor. Replacement costs are defined in the law as the gross replacement costs adjusted by accumulated depreciation for the age of the assets and for obsolescence and scrap value upon disposal. Intangible assets such as patent rights and brand names are also valued.

65. In addition, a "closing" balance sheet must be prepared as of the transformation date. The difference between the total net assets amount shown on the closing balance sheet and the total net assets amount on the transformation balance is to be charged or credited to the retained earnings of the enterprise.

66. Goodwill may be recorded as an asset if the purchase price of the enterprise exceeds the valuation of the assets and liabilities prepared for purposes of the transformation balance sheet.

67. The auditor's task of making sure that the financial statements of a privatizing state-owned enterprise are complete, prepared in accordance with generally accepted accounting principles, and provide a true and fair view of financial condition and results of operations are necessary not only for valuation purposes but also for use in the prospectus for companies whose shares are to be listed on the stock exchange. As the Act on Securities and the Stock Exchange (1990, p. 110) pointed out:

> A most crucial point of the Hungarian securities market about to be developed is the shortage of information. Investors are, in many cases, forced to make their decisions in the absence of the necessary information. This is due to the fact that for a long time issuers had no significant liabilities regarding the disclosure of information. Companies limited by shares may be formed also by an open founding, the public offering of securities has not been regulated ... and the so-called "public offering" procedure well-known in the countries with advanced capital markets has been missing.

D. The new Act on Accounting

68. Under the new Act on Accounting (1991), which takes effect as of 1 January 1992, reporting entities, referred to as entrepreneurs or economic agents, are to prepare an annual report consisting of the balance sheet, the income statement, the notes, and the business report. Valuation methods follow international accounting practices, with the following exceptions:

(a) Provisions for bad debts are not required;

(b) Inventories resulting from production are recorded at prime direct costs (direct materials and direct labour) and are not valued at the lower of cost or market;

(c) Investments of less than 50 per cent in other companies, other than temporary investments, are valued at cost. The equity method is not used as yet. Temporary investments are valued at the lower of cost or market in accordance with international standards;

(d) No adjustments are required for the effects of inflation.

A new accounting law is expected to be passed in 1992 which is supposed to deal with these matters.

69. The formats of the new financial statements are consistent with the EC's Fourth Directive. The notes are to contain numerical and explanatory data necessary for providing a reliable, true and fair view of the net assets, financial position, and the results of operations, in addition to that presented in the two main financial statements, for the owners, investors, and creditors. The comprehensive listing of items to be contained in the notes is consistent with the disclosure requirements in developed market economies. The business report is to present an evaluation of the annual report and should cover any significant events since the date on the balance sheet; data concerning the acquisition of treasury shares; and any research and development activities.

70. The most difficult matters for accountants and auditors to deal with are the recording of the costs of land and buildings, and the recording of valuation allowances for possible bad debts and for declines in the market value of inventories below acquisition and production costs.

71. The annual report, together with the auditor's certificate and the proposal or resolution as to the disposition of the after-tax profit, is to be deposited with the Court of Registration within five months of the end of the fiscal year - that is, by 31 May - where anyone may obtain information about it and make copies. This privilege also extends to the business report, which need not be filed as a part of the annual report but must be made available for inspection and copying at the reporting entity's seat of business. The annual report, including the auditor's statement but excluding the business report, must be published by companies limited by shares, limited liability companies with capital in excess of Ft 50 million, single-person limited liability companies, and economic entities issuing bonds. The notes, or parts of them, need not be published if, according to the auditor's statement, the data shown in the balance sheet and income statement are sufficient for an unambiguous evaluation of the actual net assets and the results of operations. This is not in accordance with the views expressed in Conclusions on Accounting and Reporting by Transnational Corporations, issued by the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (United Nations, 1988), because the notes are considered to be an integral, and not separable, part of the financial statements.

72. The new accounting law continues to accord standard-setting jurisdiction to the Minister of Finance. However, there is to be a new advisory group, the National Accounting Board, whose President and members will be appointed by the Minister, whose main tasks are to make recommendations about amending existing accounting standards, or creating new ones, and monitoring the implementation of the new system as well as accounting regulations and practices abroad. It is expected that the Board will have about equal representation from the Ministry of Finance, the professional body of Hungarian auditors, and leading academic accountants so as to have some diversity of experience and viewpoints. While this solution still leaves accounting and fiscal regulation under one administration, the advisory body will be helpful in broadening perspectives about the different sets of

objectives that guide the development of accounting standards and fiscal regulations in Hungary.

73. At the present time, the practicing accountants in Hungary are going through training programmes developed by the Ministry of Finance to teach the practical application of the new accounting law to their enterprises, including how transactions are to be recorded in the accounts and how financial statements are to be prepared.

E. The audit function

74. As in other non-market economies, the Hungarian expert accountant was an arm of the State in a control capacity and consequently may not be compared with the independent professional, as understood in the West. Auditing was not considered a separate discipline, and auditing manuals were primarily directed at verification, rather than analytical, techniques. In market economies, the auditing process takes place in several stages. One of the important preliminaries is the assessment of the internal control system and an analytical review, aimed at attempting to quantify the amount of audit risk. The risk assessment will be a major factor in determining the amount of detailed examination that should be performed. In addition, some of the examinations may be carried out on a sample basis, the size of the sample likely being determined statistically. Notions of statistical sampling, analytical review, and risk assessment are virtually unknown in non-market economies. Consequently, some considerable retraining is necessary in not only the basic auditing function but also the subsidiary activities that typically accompany an audit engagement, such as certain types of financial consulting. These very different types of auditor qualifications mean, of course, review of the curricula for accounting and auditing education as well as training requirements and auditor certification.

75. The State Property Agency has rules for avoiding conflict-of-interest situations. If the auditor is engaged to make the business valuation or to audit the transformation balance sheet, he or she is not allowed to purchase any assets of the enterprise or any of its shares of stock.

Notes

1/ This case-study is based in part on written contributions from the Ministry of Finance of Hungary and from Dr. Istvan J. Friedrich, International Training Center for Bankers, Ltd., Budapest.

2/ The term "economic association" denotes a commercial or industrial undertaking and does not include cooperative firms, state enterprises, or state farms.

3/ To managers accustomed to negotiating with a small group from the central Government, greater pressure could emanate from a larger group of investors.

Notes (continued)

4/ This section is drawn mainly from the Act on Securities and the Stock Exchange.

5/ For a complete listing, see Hungary Country Report, No. 4 (1990), p. 10, and Grosfeld and Hare, 1991, pp. 154-155.

6/ Zoltan (1990) is relied on for details of the Agency's operations, except as otherwise noted.

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